Internal Revenue Service
# memorandum

CC:INTL-0423-88
Brl:WEWilliams

date: SEP 2 1988

to: Ms. Florence Feiler, International Examiner

from: Senior Technician Reviewer, Branch No. 1
Associate Chief Counsel (International) CC:INTL:1

subject: How should the principles of Rev. Ruls. 76-508 and 80-231 and Treas. Reg. § 1.901-2(e)(5)(i) be applied in computing taxpayer's deemed paid foreign tax credits for [redacted]-[redacted]?

This responds to your memorandum dated June 23, 1988, in which you requested informal advice with respect to an issue involved in your examination of [redacted]'s consolidated income tax returns for the years [redacted] through [redacted].

According to your memorandum, certain of [redacted]'s foreign subs received support from other subs in the [redacted] group and, according to taxpayer, because of local law the subs receiving the support were barred from paying fees for the support. Taxpayer also asserts that the local laws prevented the subs receiving the benefits from deducting any payments for the support. The subs receiving the support were in Latin America where the benefits took the form of technical support and in Europe and Japan where the benefits mainly took the form of insurance coverage. [redacted] absorbed the costs of providing these benefits but did not deduct these costs. However, for purposes of computing its deemed paid foreign tax credit, [redacted] reduced the earnings and profits of the sub that should have paid for the service.

In addition, certain other charges were disallowed as deductions by the IRS on [redacted]'s returns, and taxpayer agreed to these adjustments. The IRS reallocated these disallowed expenses to [redacted]'s subs; furthermore, the IRS reduced the earnings and profits of the subs to which the expenses were allocated by the amount of the expense for purposes of computing [redacted]'s deemed paid foreign tax credit. The IRS also recomputed and reduced the foreign tax liability of each sub to which expenses were reallocated as a result of the reallocation.

[redacted] does not dispute that the earnings and profits of the subs were properly reduced as a result of the IRS's section 482 reallocation of expenses from [redacted] to the subs. However, [redacted] disputes the IRS's reduction in the amount of foreign tax paid by the subs to which expenses were reallocated.

The issue on which you request our advice concerns the calculation of the foreign income tax liabilities of the subs. In recomputing these tax liabilities, the IRS reduced a sub's taxable income by the expense of the services that the sub received but did not pay for and also by the expenses that were paid by [redacted] but should have been paid by the sub. As a result of reducing the foreign taxable income, the foreign tax liability was treated by the IRS as reduced. It is this reduction in the foreign tax liability that [redacted] disputes. [redacted] argues that the foreign tax liability should not be treated as reduced, because foreign law barred the subs from deducting these expenses. The IRS has taken the position that the excess taxes paid to the foreign governments by the subs should be treated as non-compulsory payments and not payments of a tax liability, because [redacted] has not satisfied its burden of proof of establishing that the expenses could not be paid or deducted locally by the subs. That is, the burden of proof is on [redacted] to establish that it followed foreign law. If [redacted] does not satisfy its burden of proof in this regard, it must show that it has exhausted its effective and practical remedies in seeking to reduce its foreign tax liability, unless foreign law is clear that [redacted] and/or its subs acted in accordance with foreign law.

Section 901(a) allows a tax credit, subject to the section 904 limitation, for the amounts provided in subsection (b) plus, in the case of corporations, the taxes deemed to have been paid under sections 902 and 960. Pursuant to section 901(b), a domestic corporation is allowed a credit for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States....[Emphasis added.]"

In T.D. 7739, adopted November 12, 1980, 1981-1 C.B. 396, the IRS promulgated Temporary Regulation § 4.901-2. Subsection (h) of the Temporary Regulation made the Regulation applicable to taxable years ending after June 15, 1979, unless the taxpayer chose to apply it to taxable years ending on or before such date. Also, subsection (h) provided that if a revenue ruling in effect on November 14, 1980 was inconsistent with the regulation, then, notwithstanding the regulation, a taxpayer could choose to apply the ruling for any taxable year ending on or before December 31, 1980. We have no information indicating that the taxpayer in this case elected to have a ruling apply, in lieu of the regulation, to its taxable year ended on or before [redacted]. Therefore, we will assume that the Temporary Regulation applies to the taxable years [redacted], [redacted], and [redacted] of [redacted]. In this regard, current regulation section

1.901-2 was adopted by T.D. 7918 on April 5, 1983, and pursuant to subsection (h)(1) is applicable to taxable years beginning after November 14, 1983; furthermore, a taxpayer could have elected to apply the permanent regulation to earlier years if an election was made before October 12, 1984, in accordance with subsection (h)(2) of the regulation. Taxpayer apparently made no such election. Therefore, the Temporary Regulation controls the periods in issue.

Temporary Reg. § 4.901-2(f)(5) provides that

> [a]n amount is not income tax paid or accrued to a foreign country to the extent that the amount exceeds liability under foreign law for income tax. An amount does not exceed such liability if-
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> (i) The amount of such liability is determined; and
> (ii) All effective and practical remedies are exhausted;
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> in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax conventions) so as to reduce, over a reasonable period of time, such liability. An interpretation or application of foreign law is not reasonable if there is actual or constructive notice that the interpretation or application is likely to be erroneous. A remedy is effective and practical only if it is reasonable to believe that the potential reduction in liability would justify the expenses of pursuing the remedy. A person need not alter its form of doing business or its business conduct to reduce its liability under foreign law for income tax.

The question of whether a remedy is effective and practical in terms of the potential for tax reduction in light of the probable expense of pursuing the remedy depends on the facts of each case. It is our view that the Temporary Regulations categorize potential overpayment of foreign tax cases as follows:

<u>Category 1</u>

Foreign law is clear that the taxpayer has incorrectly computed its foreign tax liability and has overpaid its foreign tax (<u>e.g.</u>, foreign law permits a deduction which the taxpayer claiming the foreign tax credit has not deducted on its foreign income tax return; or related taxpayers have allocated income in a manner inconsistent with foreign law). This category is illustrated by Example 9 in section 4.901-2(f)(9) of the Temporary Regulations.

Example 9 describes the situation of a U.S. corporation, A, doing business solely in the U.S. but entering into transactions with its wholly-owned subsidiary, B, a country X corporation. A reasonable interpretation of country X's laws requires transactions between related persons to be at arm's length, and pursuant to this interpretation, for 1978, $100,000 of income should be allocated to both A and B. However, A and B allocate $10,000 of income to A and $190,000 of income to B. The IRS does not audit A's 1978 income tax return. The example concludes that the amount paid to country X by B that is attributable to the $90,000 of misallocated income exceeds legal liability and is not creditable.

Under these circumstances, the only way that the taxpayer would be allowed a credit for the foreign tax that exceeds the tax computed under a reasonable interpretation of foreign law is for it to establish that it has exhausted all effective and practical remedies and that it has, nevertheless, failed to gain a reduction in the foreign tax liability. Furthermore, if the taxpayer fails to gain a reduction in foreign tax liability for procedural, as opposed to substantive reasons, where foreign law becomes clear, after payment of the tax, that a reduction in tax liability is obtainable, the excess foreign tax paid is not creditable. This point is illustrated by Example 11 in the Temporary Regulation.

Example 11 involves a U.S. corporation, C, doing business in country X. C pays an income tax to country X that is consistent with a reasonable interpretation of the laws of country X. After C's tax payment to country X, a court in country X holds that corporations organized outside of country X are entitled to a deduction that was not claimed by C. At the time of this court decision, C had time to claim the additional deduction but did not file a claim. The example holds that an amount equal to the refund that C could have received from country X exceeds legal liability and is not a creditable tax.

Furthermore, when the foreign law is clear (i.e., the taxpayer knew or should have known that it was overpaying its foreign tax) and there has been an overpayment of foreign tax resulting from a gross or egregious violation of foreign law, the foreign tax credit attributable to the overpayment will be reduced even if the taxpayer has exhausted its effective and practical remedies and has failed to achieve a reduction in its foreign tax liability. See Rev. Rul. 80-231, 1980-2 C.B. 219, discussed below.

Category 2

Foreign law is silent or unclear (e.g., it is unclear under foreign law whether the taxpayer was entitled to claim a particular deduction; or whether transactions between related persons must be on an arm's length basis), but the taxpayer is put on notice of a possible overpayment of foreign tax by a section 482 allocation by the IRS. Under these circumstances, the burden would be on the taxpayer to establish that it has exhausted all its effective and practical remedies and has failed to achieve a reduction in its foreign tax liability. This category is illustrated by Example 10 in the Temporary Regulations.

Example 10 describes the situation of a U.S. corporation, A, that owns all the stock of corporation B organized in country X. Country X has an income tax convention in force with the U.S. The convention provides that the profits of related persons shall be determined as if the persons were not related. For a taxable year, the U.S. allocates income of $20,000 from B to A under section 482. B does not seek a refund from country X and does not establish that its liability to Country X was determined in a manner consistent with a reasonable interpretation of country X's laws and the tax convention. The Example concludes that the income tax paid to country X on the $20,000 allocated from B to A is not a legal liability and is not a creditable income tax.

Category 3

A reasonable interpretation of foreign law is that the taxpayer may not claim a particular deduction, for example, that is permitted under U.S. law and that would have the effect of reducing foreign tax liability and the amount of the foreign tax credit claimed on the U.S. return (e.g., a foreign tax law might prohibit deduction of accrued but unpaid expenses; but the foreign tax is still an income tax in the U.S. sense in being imposed on net income). Under these circumstances, the foreign tax paid consistent with the foreign tax law is creditable, and the taxpayer need not exhaust any remedies in an attempt to decrease the foreign tax liability. This category is illustrated in Example 12 in the Temporary Regulations.

Example 12 describes a U.S. person, D, doing business in country X. D computes and pays its income tax liability to country X in accordance with a reasonable interpretation of country X's tax law. Later, D files a claim for refund in country X claiming a deduction the allowance of which is uncertain under country X's tax law. The example concludes that the tax reported and paid to country X by D on its original return is an income tax paid or accrued notwithstanding that D has filed a claim for refund with country X.

None of the examples in Temporary Regulation § 4.901-2(f)(9) covers a situation in which competent authority assistance is available as a means to reduce a foreign tax liability. However, we think that seeking competent authority assistance, where available, is an effective and practical remedy within the meaning of the Temporary Regulation and that, therefore, a taxpayer must go to competent authority where such a procedure is available. Support for this view is found in certain revenue rulings.

The issue in Rev. Rul. 76-508, 1976-2 C.B. 225, is whether, in a situation where income is allocated from a foreign subsidiary corporation, S, to its domestic parent corporation, P, under section 482, the IRS can reduce the amount of the foreign tax paid by S to be used in computing P's deemed paid foreign tax credit under section 902. In the factual situation described in the ruling, P made sales to S, located in country Z, at prices below P's cost. Thus, the IRS, pursuant to section 482, allocated income from S to P to reflect an arm's-length price, and S's foreign taxable income was reduced by a corresponding amount. The U.S. has a tax treaty with country Z that provides a competent authority procedure, but the parent did not request competent authority assistance to resolve the potential double taxation.

Rev. Rul. 76-508 observes that, in situations of the type described, where a taxpayer is put on notice of the possibility of obtaining a refund or adjustment of tax paid to a foreign jurisdiction but fails to take action to secure the refund, the excess tax paid may be a contribution to the foreign jurisdiction. The ruling concludes that

> [w]hen as in the instant case income is allocated to a domestic corporation from its foreign subsidiary under section 482 ..., a presumption arises that the subsidiary has made a contribution to the foreign government. This presumption will be rebutted if the subsidiary exhausts all effective and practicable administrative remedies in seeking a refund of its foreign income tax liability and if the domestic parent exhausts its rights under the competent authority procedure ....

The ruling states that in computing P's deemed paid foreign tax credit, the foreign tax paid by S, for purposes of the multiplicand in the section 902 fraction, is the foreign tax as recomputed to reflect the section 482 allocation, and that the burden of establishing what this tax will be is on P. If P fails to establish what the tax will be, "the District Director may adjust the section 902 formula by an appropriate amount of non-tax payments, such as by recomputing the amount of taxes used in the ... section 902 fraction by applying the ratio that the amount of the section 482 adjustment bears to S's total gross income."[1]/

Rev. Rul. 76-508 is amplified by Rev. Rul. 80-231, 1980-2 C.B. 219. The facts in Rev. Rul. 80-231 are essentially the same as in Rev. Rul. 76-508, except that instead of P selling products to S below the former's cost, P sells products to S at a price less than what P charges unrelated customers; also the later ruling states that P and S are on the accrual accounting method. Furthermore, the facts in Rev. Rul. 80-231 indicate that the U.S. and country Z do not have an income tax convention. The issue in Rev. Rul. 80-231 is how the section 482 allocation of income from S to P will affect the computation of P's deemed paid foreign tax credit.

Rev. Rul. 80-231 observes that in the case of an accrual basis taxpayer, adjustments to earnings and profits on account of erroneous tax overpayments affect earnings and profits for the year that the tax was accrued regardless of the year in which the excess taxes paid are refunded. Thus, in the factual situation described in the ruling, it is presumed that the excess income tax deemed to have been paid to the foreign jurisdiction will be refunded to A, and the earnings and profits of S for the year the taxes were accrued are treated as reduced.

Rev. Rul. 80-231 adopts the conclusions of Rev. Rul. 76-508 with respect to the effect that the deemed overpayment of foreign taxes by S has on the computation of P's deemed paid foreign tax credit. However, the later ruling elaborates on what is meant by P and S pursuing "all effective and practical remedies" in establishing that S's tax payments are required by

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[1]/ We note that a proposed revenue ruling that would supersede Rev. Rul. 76-508 is in the review process. The reasons for the proposed revenue ruling are the promulgation of final regulations under section 901 and the changes made to section 902 by the Tax Reform Act of 1986, P.L. 99-514, § 1202(a), effective for distributions by foreign corporations out of earnings and profits for tax years beginning after December 31, 1986, with respect to computation of the deemed paid credit. The proposed ruling does not change Rev. Rul. 76-508 with respect to the exhaustion of effective and practical administrative remedies issue. Furthermore, neither the proposed revenue ruling nor the amendments made to section 902 by P.L. 99-514 applies to the distributions in this case for the years [redacted] through [redacted].

country Z in order to prevent a decrease in foreign taxes paid for purposes of computing P's section 902 credit. That is, if P and S fail to pursue all effective and practical remedies and do not establish that S's tax payments were required by the laws of country Z, and it is established that S cannot receive a refund of the deemed overpayment of taxes to country Z because of, for example, the expiration of the statute of limitations in country Z on a refund, the amount of foreign income taxes paid, as reduced by the tax overpayment to country Z, will not be increased by the amount of the voluntary overpayment.

Furthermore, Rev. Rul. 80-231 concludes that if P and S establish that country Z will not refund the deemed overpayment of tax (i.e., P and S exhaust all effective and practical remedies), the amount of foreign income taxes paid, as reduced by the tax overpayment, will not be increased by the amount of the voluntary overpayment in certain "egregious cases". That is, where the laws of country Z (Category 1 in the Temporary Regulations discussed above) are clear and P and S knew or should have known that they were overpaying their country Z tax liability and P has grossly underpriced its products to S, the overpayment of country Z taxes will not be allowed as a foreign tax credit even though P and S exhaust all of their effective and practical administrative remedies and fail to achieve a reduction in their country Z liability. The ruling concludes that in the situations described, where the earnings and profits of S (as reduced by the tax overpayment to Country Z) will not be increased by the overpayment of taxes to Z, the earnings and profits of S are reduced by the overpayment in the year that the right to the refund becomes worthless and not in the year in which the taxes paid to Z were accrued.

In Rev. Rul. 77-267, 1977-2 C.B. 243, a U.S. corporation, Corp. X, conducted business in the United Kingdom through a branch that was considered a permanent establishment under the United States - United Kingdom Income Tax Convention of 1945. In 1976, Corp. X filed a claim for refund with the U.K. Inland Revenue for taxes on interest received by Corp. X's U.K. branch from U.S. corporations. Corp. X filed the claim for refund after learning that a similarly situated taxpayer had succeeded in obtaining a refund under the same circumstances. Subsequently, Inland Revenue offered Corp. X a settlement of the claim for refund. Corp. X has determined that it will accept the settlement that is comparable to the refund received by the similarly-situated taxpayer.

The issue in Rev. Rul. 77-267 is whether the portion of the taxes claimed by Corp. X from Inland Revenue is creditable under section 901(b). The ruling concludes that Corp. X has exhausted all effective and practicable administrative remedies in seeking refund of the tax in issue and that, therefore, the taxes retained by Inland Revenue are creditable under section 901(b). We view this ruling as falling within Category 2 explained above with respect to classification of potential overpayment of foreign tax cases and as an example of a taxpayer exhausting its effective and practical remedies under the circumstances.

The issue of what is required of a taxpayer to establish that amounts paid by a sub to a foreign jurisdiction is paid to satisfy an actual creditable tax liability was involved in Schering Corp. v. Commissioner, 69 T.C. 579 (1978). The issue in Schering Corp. was whether the taxpayer was entitled to a foreign tax credit for withholding tax paid by a Swiss sub on a dividend that was paid by the sub to the taxpayer, pursuant to Rev. Proc. 65-17, 1965-1 C.B. 833, to repatriate income that the IRS had reallocated from the sub to the taxpayer under section 482. The dividend in question was paid pursuant to a resolution of the board of directors of the sub, and a tax of 5 percent was withheld pursuant to the United States - Switzerland Income Tax Convention, rather than the normal 30 percent specified by Swiss law. No claim for refund was filed with respect to the withheld tax. However, after the IRS raised the question of the legal liability of the sub to pay the withholding tax, the sub requested and received a ruling from the Swiss tax administration that the withheld tax was correctly computed and that it represented "a legal and actual liability under Swiss tax law." Neither taxpayer nor its sub appealed this administrative ruling to the Swiss courts.

As pointed out above, one of the arguments made by the IRS in denying the credit claimed by the taxpayer for the withheld Swiss tax was that the taxpayer failed to exhaust its administrative remedies in respect of the imposition of the tax. Noting that it had concluded that the withheld tax was a legal liability of the sub under Swiss law and that the sub had taken steps, by requesting a ruling, to ascertain the position of the Swiss tax authorities, the court concluded, at page 602, that

> [p]etitioner is not required to take futile additional administrative steps and thus, on these facts, is not precluded from the foreign tax credit for its failure to do so. [Citations omitted.]

As to the IRS's position that the taxpayer should have requested competent authority assistance under the United States - Switzerland Income Tax Convention, the court observed that there was no potential double taxation, because the credit should have been allowed by the IRS. Furthermore, in footnote 17, the court rejected the relevance of Rev. Rul. 76-508 on the grounds that it was issued subsequent to the years in suit and that the revenue ruling does not take into account the specific language of the United States - Switzerland Convention.

In an Action On Decision, dated February 9, 1981, in Schering Corp., our office expressed the view that the Third Circuit was wrong to the extent that its opinion may be interpreted as concluding that no basis, other than double taxation, is grounds for a taxpayer to invoke competent authority assistance. However, the A.O.D. concludes that it could be said, as evidenced by the administrative ruling, that the taxpayer established that it had paid a proper amount of tax to Switzerland within the meaning of Rev. Rul. 76-508. Therefore, we recommended acquiescence in result only. It is uncertain what effect the promulgation of the temporary and final regulations under section 901 would have on the IRS's positions in Schering if the same issues arose under the temporary and final regulations.

In private letter ruling 7838064, dated June 22, 1978, a Virgin Islands corporation, Corp. S, was a wholly-owned subsidiary of a U.S. parent corporation, Corp. P. In [redacted], Corp. P decided to liquidate Corp. S, and the IRS gave Corp. P a favorable ruling with respect to the liquidation. Corp. S was liquidated during [redacted] and paid liquidating distributions to Corp. P in the aggregate amount of $[redacted]. Approximately $[redacted] was retained by Corp. S to meet potential liabilities. In [redacted], the Government of the V.I. issued Corp. S a Notice of Intent to Assess a 30-percent withholding tax on the liquidating distributions pursuant to sections 881 and 1441 as these sections are mirrored into the V.I. Corp. S contested the V.I.'s proposed assessment and argued various grounds for the position that Corp. P was not liable to the V.I. on the liquidating distributions. These arguments were rejected by the V.I. which issued Corp. S a notice of deficiency. Corp. S did not file a petition with the District Court of the V.I., and the deficiencies were assessed. The issue in the letter ruling was whether the withheld taxes paid by Corp. S pursuant to this assessment are creditable income taxes for purposes of section 901.

Letter Ruling 7838064 discusses Rev. Rul. 76-508 and notes that a competent authority procedure was not available to resolve disputes between the IRS and the Bureau of Internal Revenue of the V.I. However, the ruling concludes that Corp. S's efforts to dissuade the V.I. from issuing a statutory notice and assessing the tax satisfied the requirements of Rev. Rul. 76-508 and that Corp. S exhausted all its effective and practicable administrative remedies in contesting the imposition of the V.I. withholding tax on the liquidating distributions.

As to the meaning of the phrase "to exhaust all effective and practical remedies" in the section 901 context and for the taxable years in suit, IRS position is reflected in the Temporary Regulation as discussed above. The applicability of the requirement that a taxpayer exhaust its effective and practical remedies in seeking a reduction of its foreign tax liability depends on the clarity of the foreign law with respect to the item in issue, the degree of egregiousness of the position taken by the taxpayer where foreign law is clear (i.e., Category 1 in the Temporary Regulations) and taxpayer knew or should have known that it was overpaying its foreign tax liability, and whether a denial of reduction of liability by the foreign tax officials is based on procedural or substantive grounds.

As to what is required of a taxpayer to establish that all effective and practical remedies have been exhausted in attempting to convince a foreign tax authority to reduce a tax liability, there is no objective test applicable to all situations; the IRS and the one court case that we are aware of have merely addressed the question with regard to particular circumstances. In one situation, the IRS ruled that filing a claim for refund with the foreign jurisdiction and subsequently reaching a settlement resulting in a partial refund is sufficient to satisfy the effective and practical administrative remedies requirement where the settlement is consistent with settlements reached by the foreign jurisdiction with similarly-situated taxpayers. Rev. Rul. 77-267, supra. In Schering Corp., supra, the Tax Court concluded, in a conclusion to which the IRS acquiesced, that requesting a ruling from the foreign tax jurisdiction, under the facts of the case, was sufficient to rebut the presumption that the foreign sub made a voluntary contribution, and not a creditable tax payment, to the foreign tax authority. Private Letter Ruling 7838064 holds that contesting a proposed tax liability prior to the foreign tax authority's final decision on assessment will satisfy the effective and practical administrative remedies requirement, even though the taxpayer did not judicially appeal the tax authority's assessment of additional taxes.

It is our view that if a competent authority procedure is available and if the taxpayer falls within a category under the Temporary Regulations requiring it to exhaust its effective and practical remedies, the taxpayer must resort to competent authority assistance if other remedies fail to achieve a reduction in foreign taxes. As to administrative remedies, we think that the taxpayer and/or its foreign sub must take advantage of all administrative remedies that, under the facts, could reasonably be expected to achieve a reduction in the foreign tax liability if the foreign tax authority is at all inclined to reduce such liability. We do not think that advice of foreign counsel will satisfy the taxpayer's burden of proof in this regard.

We recognize that this memorandum does not provide definitive guidelines with regard to the effective and practical remedies requirement for purposes of section 901 for the years in question. However, no objective test may be possible, and we have only attempted to provide some general guidelines in light of the Temporary Regulations that were in effect during these years, and the outstanding rulings and one court decision on the issue. If you will forward actual facts concerning the administrative steps taken by [redacted] and its subs to achieve reduction in the foreign tax liabilities of the subs, we will be glad to provide you with our views on the specific circumstances.

If we can be of any further assistance in this matter, please call Ed Williams at FTS 287-4851.

(Signed) George M. Sellinger

GEORGE M. SELLINGER